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BANK OF MONTREAL
Established 1817

Brief to the House of Commons Standing Committee on Finance, Trade & Economic Affairs

Submitted by

The Bank of Montreal

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SUMMARY

. The Bank of Montreal's profits, while large in total volume, have not been "excessive" in terms of the two most generally accepted measures of bank profitability:

-- Return on assets has been remarkably consistent over the years, accurately reflecting the predominant role of asset growth as a determinant of profit growth.

-- Return on equity has risen since the early 1970s, but not as rapidly as either inflation or rates of return expected by existing and prospective shareholders.

. The Bank's profits have not been sufficient to meet, through retained earnings, the need to keep its capital base growing in line with asset growth. However, they were sufficient to enable it to raise in the marketplace the capital and deposits required to support the large increases in loan volumes.

. Profits were not sufficient, however, to maintain the value of Bank of Montreal shares on the market: the price of the Bank's common shares has dropped roughly one-third, from previous highs just over one year ago.

. The Bank's international business has been growing more rapidly than its domestic. Funds for international lending are raised entirely abroad; in addition, the Canadian banking system channels billions of dollars of foreign deposits to Canadian borrowers every year.

- Banks do not profit from high interest rates. The principal determinants of a bank's profits are volume and spread* -- the difference between what it pays for deposits and what it collects on loans. Spread can be influenced by rapid rises or falls in interest rates, which are due to leads and lags in the financial system, but such influences are temporary, and over time the upward and downward trends tend to cancel each other out. Last year, when the prime rate was at a record high level, the Bank's spread was slightly below its five-year average.**
- Banks are not, however, immune to the effects of high interest rates. While the Bank's deposit base grew by almost two and a half times since 1977, interest expense rose more than six times. Savers benefit from high interest rates. The banks themselves face heightened risk; high interest rates hurt borrowers, and, accordingly, loan losses for banks are increasing.

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* See Appendix 1 (attached) for definitions of banking terms.

**All figures in this brief are reported in accordance with the Bank Act of 1967 with the exception of those for fiscal year 1982, which are reported in accordance with the Bank Act of 1980. Bank fiscal years begin November 1 and end October 31.

I. INTRODUCTION

The question of bank profits cannot be separated from the question of the soundness of the banking system.

The chartered banks play three essential roles in the Canadian economy.

- They are the key participants in the nation's payments system, the core of day-to-day economic life.
- They serve as safe repositories of Canadians' savings.
- Through the lending process, they serve as mobilizers of savings to finance economic growth.

If banks are to perform these roles effectively, they must remain sound in good times and bad.

Banks can remain sound only if they increase their capital in line with growth in their loans and other assets. A key function of bank capital is to provide a cushion against unexpected losses, thus assuring the safety of depositors' savings. The ratio of capital to assets is the measure of a bank's capacity to handle risk. Capital adequacy is thus essential to public confidence in banks.

Profits contribute to capital both directly and indirectly. About 70% of the profits of chartered banks are retained and thus are added directly to the capital base. Profits also contribute indirectly since they are the source of dividends, which must be sufficient to enable banks to

raise equity capital in the market -- the other main source of capital.

In short, if banks are to be in a position to perform their essential roles, as they increase lending they must also increase profits.

Canadian banking is a classic high volume, low margin business. The volume of the Bank of Montreal's business is measured in billions of dollars, its profits in millions. Yet its rate of profitability is measured in only fractions of a single percentage point.

The Bank of Montreal's lending has increased substantially in recent years. In 1967, for example, after 150 years in business, the Bank of Montreal had \$6.1 billion in assets. Fourteen years later, by the end of 1981, assets totalled \$63.8 billion.

Over the past few years, the Bank has experienced a rapid surge in loan volumes, due in large part to the aberrant behaviour of the economy. The combination of high and volatile interest rates together with high inflation gravely weakened the corporate bond market. Lenders, faced with greater uncertainty and greater risk, became increasingly reluctant to tie up their money for long terms. At the same time, the federal and some provincial governments, in a period of heavy deficit financing, were making use of most of the bond market's diminished capacity

to raise long-term funds.

The combination of market weakness and government demand forced corporations to postpone long-term capital financing. They turned instead to the banks for short- and medium-term assistance. In effect, the banks became lenders of last resort for business constrained by the difficult economic climate (see Appendix 2). Over the past two years, the bulk of the Bank of Montreal's loan growth resulted from business borrowing; business loans grew 82.6%, while consumer loans rose only 35.0% since 1979.

There was also a period of heavy borrowing for the purpose of financing takeovers. This was particularly so in the first half of 1981, notably in the energy field, as Canadian corporations hastened to take advantage of the terms of the National Energy Program.

The banks, in short, faced a period of extraordinary demand for funds -- extraordinary in terms of both quantity and motivation. The unusual volume of loans caused the total volume of profits to rise to record levels. Bank profitability, however, did not rise. It remained at no more than average levels.

Some of the anomalies that caused loan volumes to rise so rapidly seem now to be disappearing. In the last quarter of 1981 and the first two quarters of this year, the growth rate of the Bank of Montreal's business fell off sharply. In

the first half of this year, the volume of profits as well as the level of profitability dropped dramatically.

The volume of profits last year nonetheless has given rise to the question: were profits excessive? An equally pertinent question is: given their role, were they adequate?

II. ARE BANK OF MONTREAL PROFITS EXCESSIVE?

Return on Assets

Bank profitability is most commonly measured by return on average assets -- that is, the net profit earned from each $100 block of assets.

Since 1972, the Bank of Montreal's annual return on assets has averaged 57 cents per $100 (compared to 58 cents for the banking industry as a whole). In the last five years, average return improved slightly to 63 cents per $100 of assets (compared to 56 cents for the industry as a whole). This resulted mainly from improvements in operating efficiency and from the resolution of some financial and management problems at the Bank in the early 1970s (see Chart I, also Appendix 3).

Last year's return was 64 cents, making 1981 an average year in terms of longer-term trends in Bank profitability. In the first half of 1982, annualized return on assets fell abruptly to 42 cents. Such extreme short-term fluctuations are usually temporary. The only anomaly in the last decade came in 1974, when annual return on assets plunged to 35 cents per $100.

These figures (0.57% for ten years, 0.63% for five years, 0.64% last year) translate into rates of return of about six-tenths of one percentage point. Though shifts of

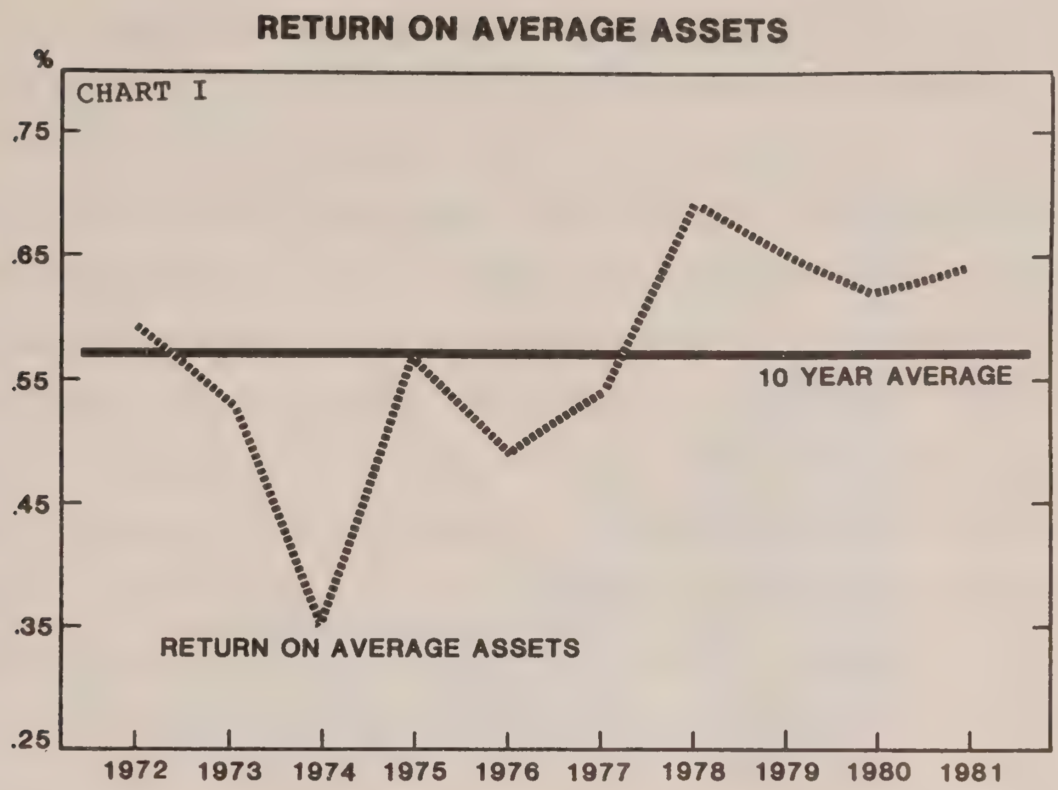


CHART I

A ten-year history of the Bank's return on assets - a profitability measurement which enables one to compare the profitability of banks of different sizes, or of a given bank from one time period to another.

The Bank's profits have ranged from a low of 35 cents on each $100 of assets in 1974 up to 69 cents in 1978. Over the last five years, return has averaged 63 cents, with the last three years in particular showing very little movement around the average:

1979 - 65 cents
1980 - 62 cents
1981 - 64 cents

0.05% or 0.10% are of vital significance to the Bank to maintain investor confidence, they account for an infinitesimal portion of the economy's cost of borrowing.

By the same token, the Bank's management must strive to maintain profitability within an extremely narrow margin.

In fact, virtually all the improvement in Bank profitability over the longer term has come from improvements in productivity. For example, in response to burgeoning transaction loads and increasing costs of processing, the Bank has invested heavily in computer technology, which has greatly increased efficiency. Since 1977, while Bank assets have grown by 153%, the number of employees has grown by only 6.9%. Over the same period, overhead expenses have grown at about two-thirds the asset growth rate (see Appendix 4).

The remarkable stability of Bank profitability over time results most directly from the fact that profits tend to grow on average at the same pace as assets. Since 1972, both assets and profits have increased by exactly 465%, an annual compound rate of 21.2%. Over the long haul, growth in dollar volume of profits has been almost entirely due to corresponding growth in the volume of loans and investments, and only marginally to improvement in profitability (see Chart II, also Appendix 5).

In some years, assets grow more quickly than profits; in others, vice versa. A variety of factors account for this: short-term fluctuations in interest rates, sudden bursts in loan growth, overhead costs and management decisions. But the long-term trend has been to parallel growth.

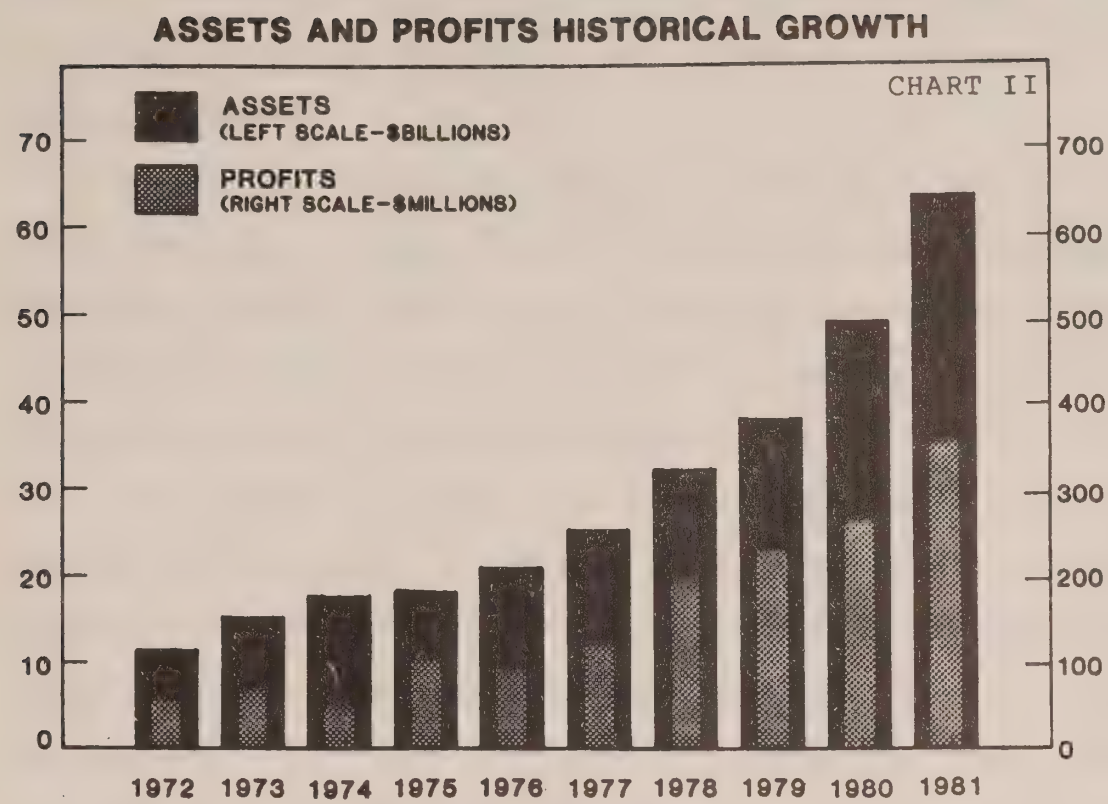


CHART II

A ten-year history of year-end assets and profits.
Since 1972, the trend has been for assets and profits to grow in parallel. The driving force behind profit growth has been growth in the Bank's dollar volume of business.

In recent years, the trend has been for assets to grow more quickly than profits. Since 1979, assets have grown at an annual compound rate of 29.2%, profits at 25.2%. Last year, that trend was temporarily reversed, with assets growing 30.7% and profits 36.2%. In the first half of this year, however, assets grew 15.3%, while profits declined

24.7%, when compared to the same period last year. Such temporary gains and reversals tend to cancel each other out.

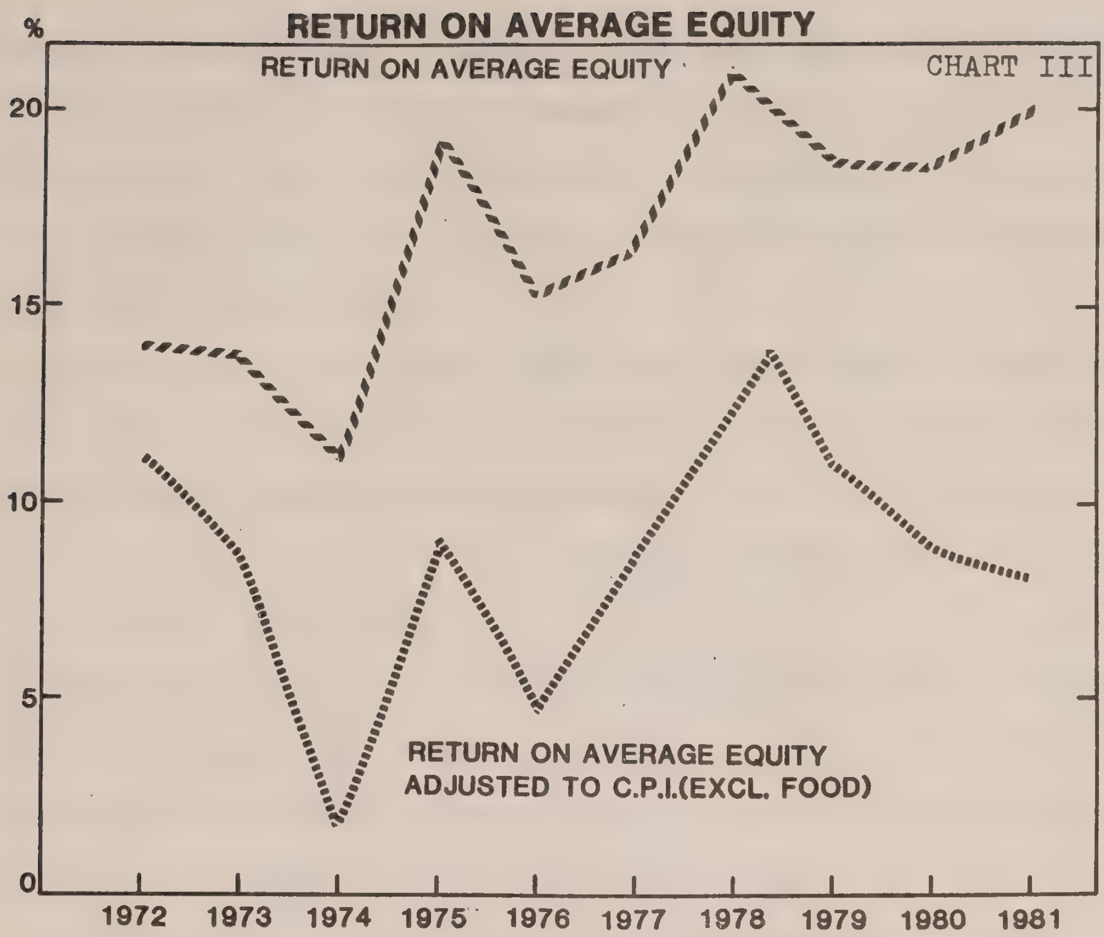
Return on Equity

Return on equity is another standard gauge of bank profitability. This measure helps investors to compare investment opportunities among different industries or among firms in the same industry. It is not, however, a measure of the market yield to holders of bank shares.

Over the past decade, the banking industry's return on equity has improved steadily. The pattern of increase, however, has served only to maintain banks' ranking in the upper third of major Canadian industries in terms of return on equity. From 1971 to 1980, the chartered banks ranked 11th among 33 industrial groupings.

The Bank of Montreal's return on equity has averaged 16.8% over the last ten years, 18.9% over the last five years, and stood last year at 20.0% (see Chart III, also Appendix 6). This is somewhat higher than that of the banking industry as a whole. The advantage has been slight, however, and has not resulted in a better share performance relative to other banks.

Since 1972, the Bank of Montreal's return on equity has improved, although not on a steady course. Gradual improvement in the return on assets has helped. But a powerful force behind the improvement has been the fact that



<u>CHART III</u>

<u>What the Bank is earning on shareholders' investment.</u>

ROE has averaged 16.8% over the past 10 years, and last year's return of 20% was in line with the five-year average of 18.9%. However, ROE adjusted for inflation has been substantially lower and has actually declined in recent years. The inflation adjusted ROE was actually lower last year than it was in 1972.

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for most of this period assets, and the dollar volume of profits, have grown more quickly than the Bank's equity base -- and as a consequence, more profits were earned per dollar of equity. The other side of the coin, of course, is a decline in the ratio of capital to assets. Accordingly, for

reasons of financial prudence, the Bank has taken decisive action to reverse the trend towards a declining capital ratio and, today, this ratio stands at its highest level since 1972. Other things being equal, this will tend to reduce the Bank's return on equity.

Given the fact that relatively slow equity growth can make only a temporary contribution to return on equity, it is questionable whether the improvement has been sufficient -- especially in the context of general economic, financial and stock market conditions.

The increase in the Bank of Montreal's return on equity has not kept pace with inflation. For the investor, persistent inflation has meant that a return on equity of 20% in 1981 was lower in real terms than, say, the 16.5% return on equity in 1977. The Bank's return on equity, adjusted for inflation, has consequently declined over the past five years (see Table below).

Year	Return on Equity	CPI (ex-food)*	ROE-CPI
1977	16.5%	7.8%	8.7%
1978	20.5	6.4	14.1
1979	18.9	7.9	11.0
1980	18.6	10.0	8.6
1981	20.0	12.8	7.2

Source: Statistics Canada
*Food prices, which are volatile, are frequently removed from the CPI to give a more reliable measure of Canada's "core" inflation rate.

Nor has return on equity risen as quickly as interest rates. The erosion of the so-called risk premium demanded by equity investors has been dramatic when Bank of Montreal returns are compared to the short-term interest rates on virtually risk-free Government of Canada Treasury notes. When adjusted for rising interest rates, especially short-term rates, return on equity has tended to decline in the last five years (see Table below).

Year	Return on Equity	Average Rate/ 90-day Treasury Notes	ROE- Treasury Notes
1977	16.5%	7.5%	9.0%
1978	20.5	8.1	12.4
1979	18.9	11.2	7.7
1980	18.6	12.5	6.1
1981	20.0	17.8	2.2

Source: Statistics Canada.

In addition, and perhaps more importantly, return on equity figures do not reflect actual market return to shareholders. Capital gains have been limited by sluggish share price performance on the stock market. And dividend yields are limited by the fact that the Bank has found it necessary to retain about 70% of its earnings to service its capital base.

Judgement of Investors

Indeed, investors' judgement about bank shares is a third indication of profitability.

For some years, investors have been concerned about bank profitability and, more recently, about the mounting risk exposure in banking resulting from weakening corporate balance sheets, volatile interest rates, and slow economic growth. This concern has been reflected in downward pressure on the price of bank shares. For a decade, in fact, the price appreciation of Bank of Montreal shares (and bank shares in general) has consistently lagged behind that of the Toronto Stock Exchange composite index. Bank price/earnings ratios have also been consistently lower than those of the TSE composite ratio (see Appendix 7).

Annual market rates of return to shareholders on Bank shares, including both capital gains and dividends, illustrate the reasons for investor concerns. For a shareholder who bought Bank stock at the end of 1971, and sold at the end of 1981, the annual market return would have been 9.8% -- in stark contrast to the Bank of Montreal's ten-year average return on equity of 16.8%. For the five-year period 1977-81, the annual market return on Bank of Montreal shares would have been 17.9%, one percent less than average return on equity over the same period. In the most recent two-year period, the annual market return to shareholders fell to 12.7%, again well below the Bank's average return on equity of 19.3% for the same period. By way of comparison, shares in the Toronto Stock Exchange

composite index would have offered somewhat higher annual market returns to investors -- 11.9% over ten years, 18.4% over five years, and 13.2% over the last two years (see Appendix 7).

It is relevant in this connection to recall precisely who has a stake in bank share performance. The Bank of Montreal is 95% Canadian owned. It has 81,000 common and preferred shareholders -- some of them wealthy, the great majority not. Among shareholders are many pension funds and insurance companies. Through these institutions, the millions of Canadians with insurance or pension plans also have a stake in the Bank's profits (see Appendix 8).

<u>Conclusion</u>

Bank of Montreal profits have clearly not been excessive by either of the usual standards of measurement or in the judgement of investors.

Indeed, as will be seen in an examination of the Bank of Montreal's capital base, the more realistic question is, are bank profits adequate to do their job?

III. ARE PROFITS ADEQUATE?

The main job of profits, as has been stated, is to strengthen the capital base and thus to safeguard public confidence in the banking system.

The confidence of depositors, for example, is critical to the smooth functioning of the Bank, since they provide about 95% of the funding for the Bank's loans and investments. Another 3.75% comes from equity, while the remainder comes from the sale of long-term debt instruments such as debentures.

The capital base must be built in line with asset growth. Bank capital adequacy is clearly in the public interest. Only a sound capital-to-assets ratio can ensure that shareholders, not depositors, bear the heightened risks associated with rapid asset growth.

There is no formal yardstick to determine how much capital banks should maintain in relation to loan volume*. Indeed, the prudent ratio of capital to assets for a bank will vary somewhat depending on the risks characteristic of its loans. Market forces and prudence dictate required capital-to-assets ratios.

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*Although there is as yet no legal definition of what constitutes adequate capital, the 1980 Bank Act gave the Minister of Finance the power to establish regulations. The Inspector General of Banks has recently indicated that a further decrease in capital-to-assets ratio of the Canadian banking system would not be appropriate.

A capital-poor bank can be seen as a credit risk, particularly by institutional domestic and foreign depositors, who can bring pressure to bear by withdrawing their funds or charging the bank higher interest for the use of their money. This in turn would force a bank either to reduce its lending or increase interest rates on its loans.

The fact that the Bank of Montreal's soundness remains unquestioned is due in no small part to its maintenance of an adequate capital base. Capital adequacy is critical to the Bank's ability to deal regularly and in large dollar volumes on world and Canadian money markets. To mobilize funds quickly, as was necessary in the recent surge in asset growth, a bank must keep the confidence of institutional investors and "wholesale" depositors. A strong capital base permits the Bank to raise large amounts of deposit funds at wholesale cost and to pass along those savings to borrowers.

Sources of Capital

The most readily available source of capital is retained earnings. But assets have grown so quickly in the past five years that even by retaining 70% of its earnings, the Bank has had difficulty keeping its capital base expanding at what it considers a satisfactory pace. From 1977 to 1981, the Bank's retained earnings of $800 million could have sustained asset growth of about $25 billion, or roughly six-tenths of

the actual asset growth of $43.3 billion.*

The Bank has maintained a prudent ratio of capital to assets. Yet retained earnings have quite clearly been insufficient, by themselves, to meet rapid growth in capital needs. This indicates that return on assets has not improved quickly enough to support the growth in assets that the Bank has been called upon to supply.

The Bank, therefore, has at times taken steps to moderate the rate of asset growth, particularly in international markets, to the extent considered feasible under highly competitive conditions. In the main, however, it has turned more and more to the other principal source of bank capital, equity raised from investors in the stock market and debentures. Equity, the only permanent type of capital, has been especially difficult to raise. The reason is basically the same: Bank profitability has not been high enough -- in this case, to maintain the Bank's share-price performance. By expanding equity, moreover, the Bank has put downward pressure on return on equity, which has further eroded the market price of its shares. From the Bank's standpoint, undervalued shares drive up the cost of raising new equity, while high interest rates drive up the cost of issuing debentures.

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*This assumes that the Bank maintained a constant capital-to-assets ratio of 3.3% in this period, this being quite close to its actual average ratio. The ratio was 3.8% at April 30, 1982, the latest date for which figures are available.

In short, the demand of the Bank of Montreal's customers for credit in recent years has made it very difficult for the Bank to keep its capital base growing at what it deems a prudent rate. At times over the past ten years, the Bank's capital-to-assets ratio has been eroded (see Chart IV, also

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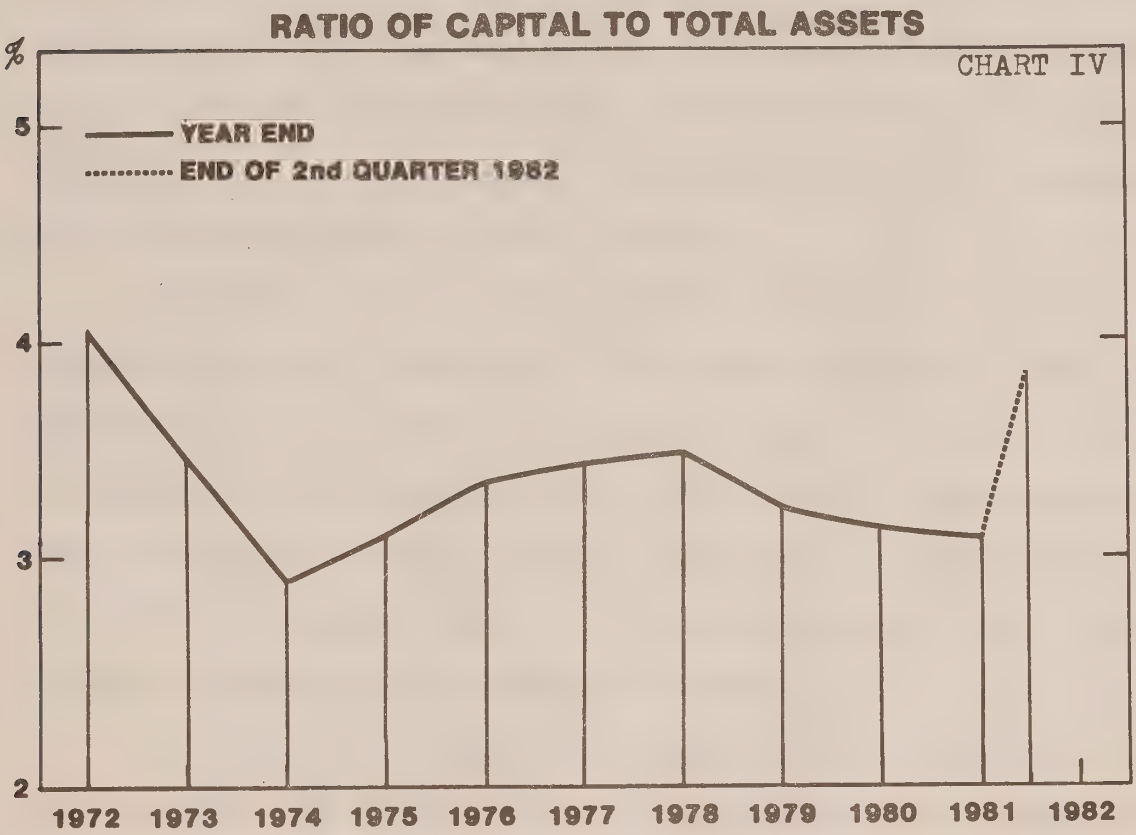

CHART IV

Ratio of capital (excluding debentures) to total assets over ten years.

As the chart indicates, this ratio has declined during the past decade, but has remained at prudent levels. Since October, 1981, the Bank of Montreal has substantially increased its ratio to the highest level in almost a decade. (Ratio at October 31 each full year and at April 30, 1982.)

Appendix 9). Each time, however, the Bank has taken decisive action to remedy such lags in capital expansion. It has sold shares on the market and introduced a variety of share-conversions and a dividend-reinvestment plan.

During 1981, the Bank and its subsidiaries raised over $1 billion in new capital, of which $475 million was equity, the balance debentures. In a period when the risks of lending have been increasing, the Bank has worked exceedingly hard to build its capital base. At $3.14 billion (including $741 million in debentures), it is now one of the strongest in relation to assets in the industry.

If banks ever faced really serious problems in maintaining their capital, the impact could be felt well beyond the stock market. The banks would in prudence have no alternative but to restrict the growth of the "asset side" of their capital-to-assets ratio. Bank credit would have to be curtailed, thereby raising borrowing costs and putting further strains on the Canadian economy.

The Bank of Montreal in recent years has worked its capital base at 100% capacity to produce fresh loans for Canadian businesses, industries, exports, farmers and homeowners. What might have happened had the Bank of Montreal, and other banks, been unable to meet the extraordinary surge in market demand for credit in Canada?

International Lending

Some critics argue that in order to prevent assets from outgrowing the capital base, Canadian banks should limit international lending. This would both relieve pressure on the banks' capital base and increase the dollar volume of lending in Canada.

This proposal ignores the substantial contribution Canadian banks make to the Canadian economy precisely because they have such a strong presence in international markets.

In a country such as Canada, where exports account for about 30% of GNP, it is essential to have world-class Canadian banks. But neither the Bank of Montreal nor any other Canadian bank could maintain its international standing simply by relying on Canadian export business.

The Bank of Montreal operates in international markets as lender, deposit gatherer and syndicated loan manager, in addition to its role as specialist in trade financing. Financing arrangements are now a key element in winning major trade contracts. To give Canadian business an advantage, Canadian banks must maintain an extensive presence in foreign money markets.

The Canadian banks' presence in world money markets is strengthened by their size, incidentally. As it is, the Bank of Montreal, while the third largest in Canada, is only the 50th largest in the world. The Bank must compete with the

world's banking giants for the business of large multinational corporations and foreign government accounts. If the Bank were smaller, it might not have the competitive punch to vie for business with the strongest banks of the United States, Europe and Japan.

The international activity of Canadian banks contributes to the Canadian economy in other ways besides servicing Canadian exporters and Canada's potential customers. It is an export industry. When the Bank of Montreal does business abroad, it is exporting Canadian banking services and expertise. The profits on these services return to Canada, helping the national balance of payments.

In the last five years, international profits and assets* have grown rapidly -- from about a quarter of the Bank's total in 1977-79 to about a third in 1981. International profitability was higher than domestic return on assets in all years but 1981. International lending, in other words, contributed relatively more to profit growth than did domestic lending (see Appendix 10).

Apart from the positive contribution this makes to Canada's balance of payments, these profits, once brought home, are either distributed to Canadian shareholders as dividend payments or retained to support more lending.

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*defined as assets and profits of the Bank's international division and related operations in Canada.

Some people advocate limits on international lending, not because they are concerned about the growth of bank lending in relation to capital, but because they believe that Canadian deposit money is drained off to support foreign loans.

What is not realized is that funds for lending abroad are raised entirely in foreign currency on world financial markets. Indeed, far from reducing the amount of deposits available for lending in Canada, the international operations of Canadian banks actually channel billions of dollars of foreign deposits to Canadian borrowers each year.

Net funds raised abroad by chartered banks for loans to Canadian residents have increased fairly steadily from $1.4 billion in 1977 to $17.9 billion last year. Quite clearly, in recent years, Canadian customers of chartered banks have consistently been borrowers from the world money markets, not lenders of money to foreign countries.

<u>Conclusion</u>

Since 1977, the Bank of Montreal's assets have grown quickly, at an annual compound rate of 26.1%. This was possible only because of the Bank's ability to assemble the capital required to support that growth. That ability was vitally dependent upon the Bank's profits.

IV. MISCONCEPTIONS ABOUT BANK PROFITS

High Interest Rates and Competition

Much of the public concern about bank profits seems to arise from a perception that the "big five" chartered banks dominate the Canadian financial scene and unilaterally set interest rates to guarantee healthy profits.

On the contrary, banking, at both the international and domestic levels, is fiercely competitive. In Canada, the Bank of Montreal competes in a wide range of products and services with 55 other banks, 44 of them newly chartered foreign banks, many of which were operating under a non-bank status until passage of the 1980 Bank Act. The Bank also competes for deposits and consumer and mortgage lending business with trust companies, mortgage loan companies, credit unions, and caisses populaires (see Table, next page). Since there are between 50 and 200 major competitors in its various markets, the Bank must offer competitive interest rates on its loans and deposits -- as well as the highest quality services -- if it is to stay in business.

The general uniformity of interest rates has often been cited as evidence that banks do not compete freely. In fact, interest rates adjust quickly to uniform, nation-wide levels because of competition, not for lack of it. Interest rates are widely publicized and depositors are free to shift their

Table

Number of Major Institutions (by category) Competing with BoM*

Market	Total	Banks	Trust & Mort. Loan Co's (est)**	Credit Unions, Caisses Pops. (feds.)	Quebec Saving Bank	Ins. Co's (est)**
deposits	174	55	105	13	1	-
consumer loans	149	10 (Sch.A)	40	13	1	85
mortgage loans	206	12	105	13	1	75
commercial loans	56	55	-	-	1	-

*In addition, the Bank faces many other competitors in banking related functions, eg. automobile companies (for car loans), department stores (for credit cards) and consumer loan companies.

**Though some underestimation is likely, these figures fairly reflect the number of major competitors in these two categories (the sample of insurance companies, for example, included only those that were federally incorporated). Commercial lending by mortgage, loan and insurance companies is not accounted for in the table.

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money from one financial institution to another in search of the highest rates; credit unions and trust companies offer interest rates at generally the same level as banks. Similarly, most borrowers are well informed as to the terms available in the marketplace. Central bank regulation of the money supply reinforces the uniformity of rates.

It is the market that sets the level of interest rates. The rate that banks charge their most creditworthy customers -- the so-called prime rate -- is set by each bank in response to economic factors to achieve a commercially viable income while meeting the competition. The bank's prime rate is not a cause of the cost of money, but a consequence of the cost of money from savers, and of government policies. The Government of Canada, through its monetary, fiscal and other policies, and the Bank of Canada have a major influence on the level of nominal interest rates.

While banks are not in control of the level of interest rates, and are not in a position to subsidize entire sectors of the economy, no group is more directly involved in efforts to solve the problems of those most immediately affected by extraordinary interest rates: Canada's farmers, small businesses and mortgage holders. The banks have kept funds available to these groups -- in many cases through innovative financing plans.

High Interest Rates: Who Benefits?

Another public misconception is that banks profit from high interest rates. They do not. Historically, whether the prime has been set at 5% or 20% has been largely irrelevant to bank profit levels. For example, over the five-year period from 1977 to 1981, when the average Bank of Montreal prime lending rate rose steadily from 8.77% to 18.91%, the

Bank's rate of profitability -- measured in terms of return on average assets -- fluctuated around an average of 63 cents per $100 (see Chart V, also Appendix 11). Last year, when the Bank's prime

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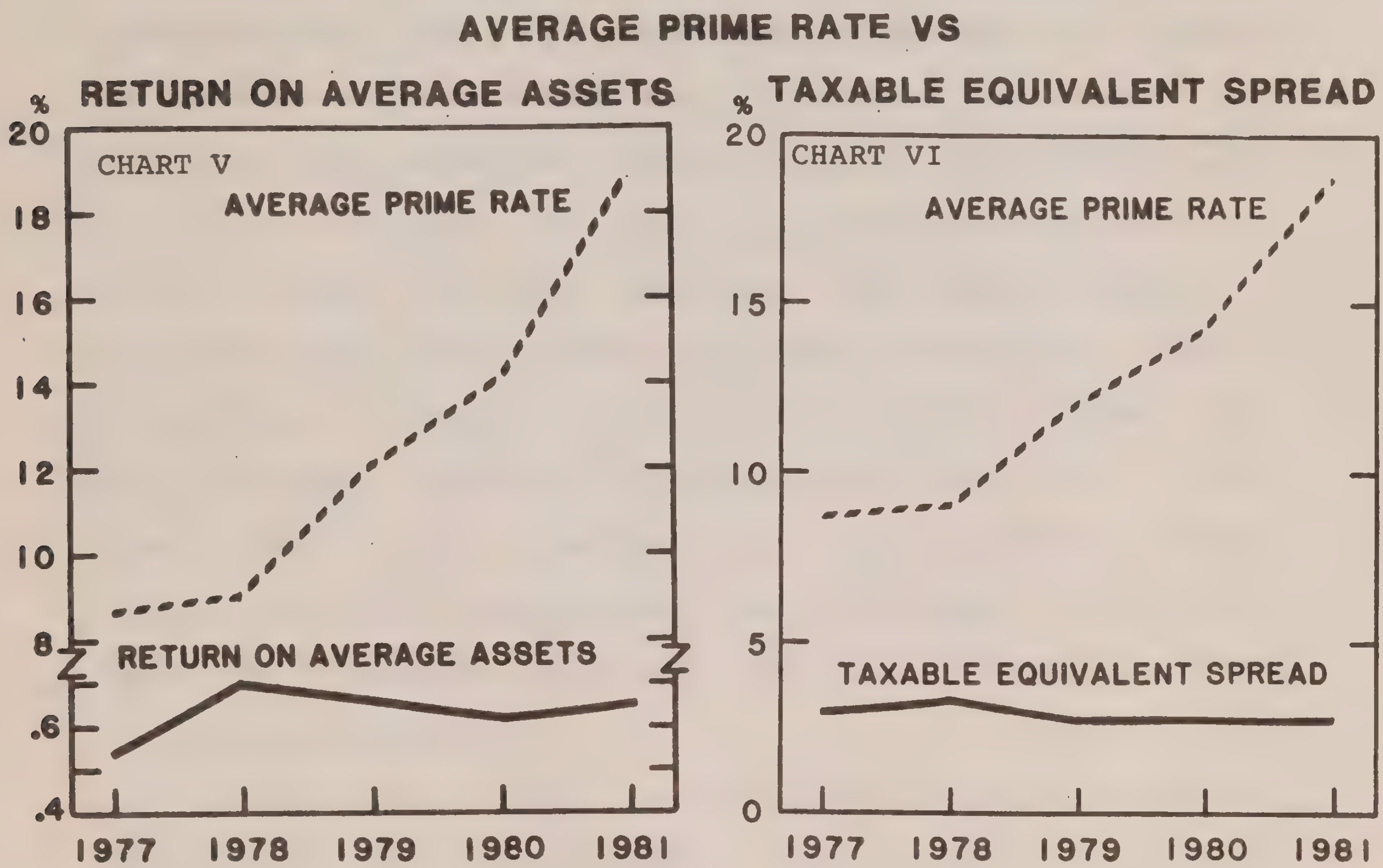


<u>CHARTS V & VI</u>

<u>A five-year history of the average prime rate compared to the return on average assets and 'taxable equivalent' spread.</u>

Spread is the gross difference between the rate the Bank earns and the rate it pays. Because some income is received on an after-tax basis, in order to make all the figures truly comparable, this income must be recalculated as if it had been received on a before-tax basis. This is known as the 'taxable equivalent' basis. Although the Bank's prime rate has risen steadily for the past five years (from 8.77% to 18.91%), spread has in fact been declining while return on assets has remained relatively stable. This indicates that high interest rates do not improve the Bank's spread.

averaged 18.91%, profits were 64 cents per $100 of assets. In other words, profitability remained remarkably consistent over a period during which the prime nearly doubled. In the first half of this year, the Bank experienced lower profitability. With the prime rate averaging 17.1%, return on assets fell to an annual rate of 42 cents per $100.

The two principal determinants of bank profits are volume and "spread". The volume of the Bank's business, as noted earlier, has grown immensely. The Bank's spreads -- the difference between what it must pay for funds and what it can collect on loans -- have remained fairly constant over the long haul. Over the five-year period from 1977 to 1981 (see Chart VI, also Appendix 11), when the Bank's average prime rate more than doubled, spread averaged 3.01%. Last year, with the prime at 18.91%, the Bank's spread was 2.84% -- lower, not higher.

In the short term, interest rates have an effect on spreads and thus on bank profits, but the effect has little to do with whether rates are high or low. It has to do with shifts, particularly volatile shifts, in the level of interest rates. When interest rates are in a phase of rapid climb, spreads tend to widen. This is because the floating rates on many of the Bank's commercial loans -- the rates tied directly to prime -- move up more quickly than the average interest rate on deposits. This is because a portion

of those deposits are for fixed terms, with interest rates which are adjusted only when the deposits mature. But this lag in deposit rates is temporary, and it applies in reverse when interest rates go down. During periods of rapid decline, lending rates drop more quickly than deposit rates.

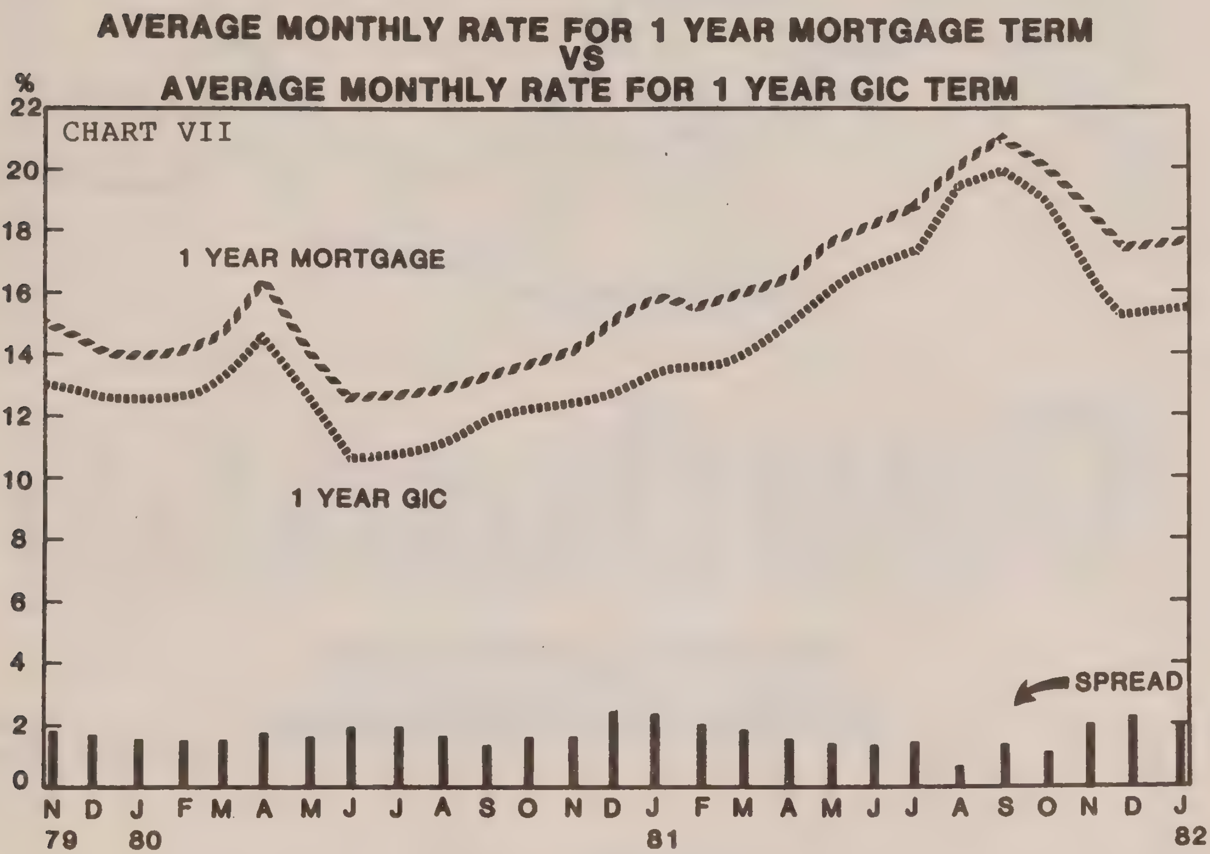
In short, upward and downward trends cancel each other out over time. In the first quarter of this year, for example, the overall trend was downward. During the first eight weeks of the quarter, the Bank of Montreal's prime rate dropped 3.5 percentage points, and the result was both a notable narrowing in spreads and a notable decline in first quarter profits.

Some Canadians believe that the Bank has widened specific spreads, notably those on retail and commercial loans. The fact is that although specific spreads have varied over time, average Bank-wide spread has remained remarkably consistent over the longer term (see Charts VII, VIII, and IX, also Appendix 12).

High interest rates, far from benefiting the banks, have a negative effect on them. The most important impact is on deposit costs. The volume of Bank of Montreal deposits has grown almost 2½ times since 1977 -- from $23.0 billion to almost $54.6 billion. Interest costs increased more than six times. In 1977, the Bank paid a total of $1.1 billion to depositors. Last year, it paid $6.8 billion to depositors for

only 2½ times the volume of deposits.

To look at these figures from another perspective, since



<u>CHARTS VII, VIII & IX</u>

<u>Spreads</u>. The three charts above and on the next page portray spreads between the rates of interest on the following instruments:

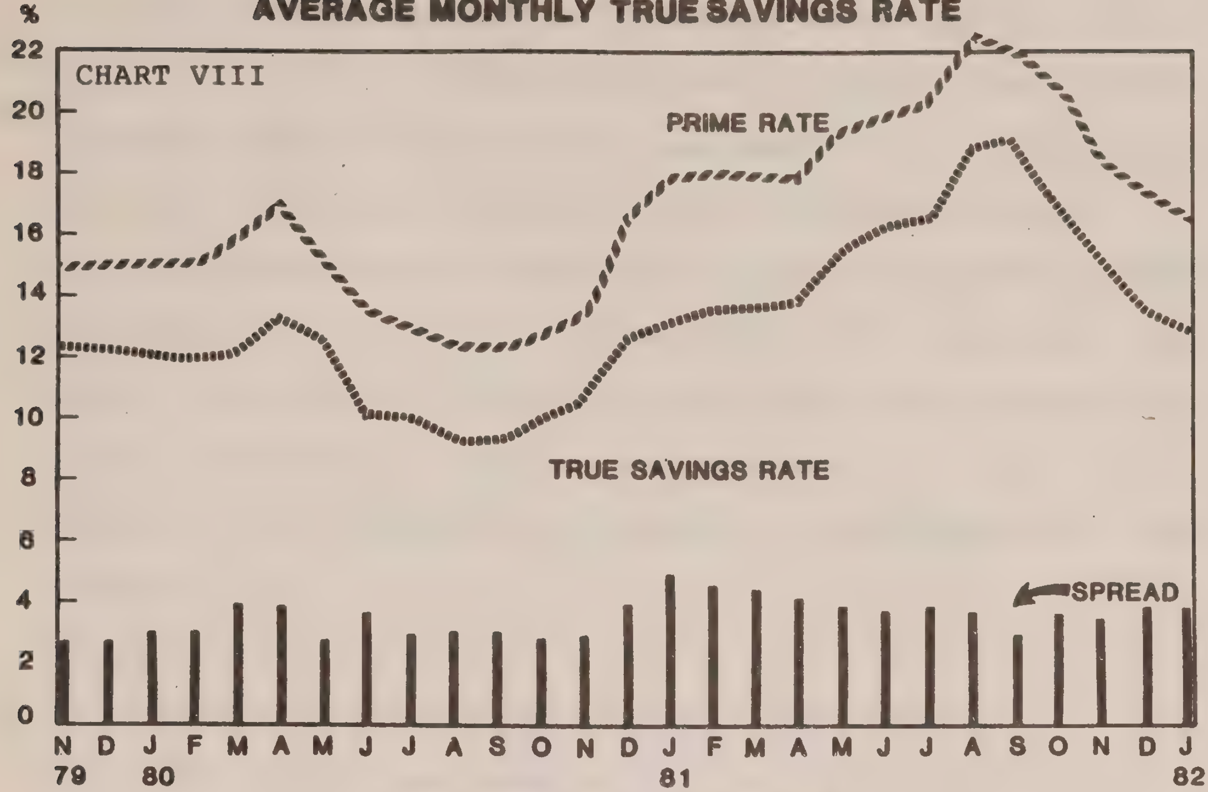
a) The rate paid to raise money for a one year mortgage (through Guaranteed Investment Certificates) compared to what the Bank can charge for that mortgage.

b) The Prime Rate (which is the rate charged to the most creditworthy customers) versus the True Savings Rate.

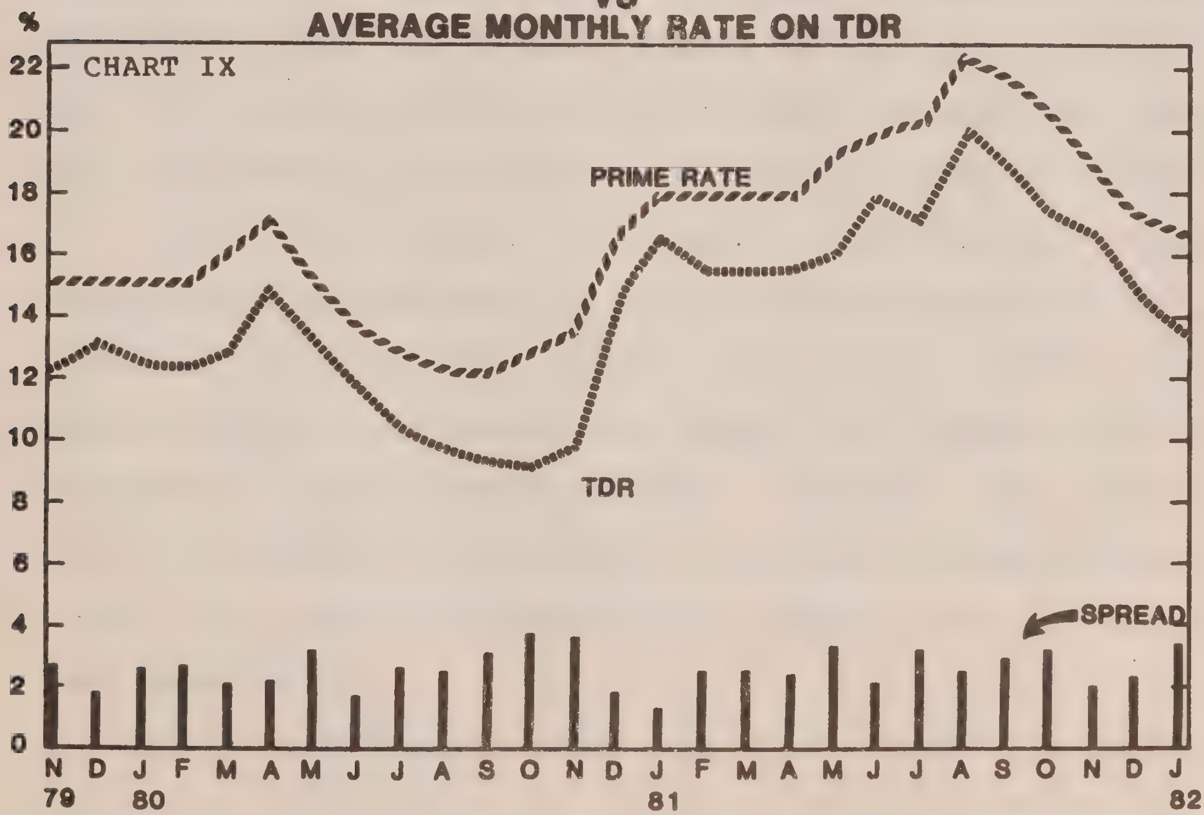
c) The Prime Rate versus the Term Deposit Receipt Rate (which is a cost of raising large amounts of funds).

It is apparent that on a monthly basis, some variation is evident in all three charts; however, over time Bank-wide these variations tend to cancel each other out. Overall Bank spread has consequently remained remarkably consistent over the years.

AVERAGE MONTHLY PRIME RATE
VS
AVERAGE MONTHLY TRUE SAVINGS RATE



AVERAGE MONTHLY PRIME RATE
VS
AVERAGE MONTHLY RATE ON TDR



1977 the Bank's interest revenue grew at an annual compound rate of 45.5%, ten percentage points lower than interest expenses, which grew at 55.7% (see Appendix 13). Savers have benefited from high interest rates; the banks have not.

A second negative effect of high interest rates on banks is the growing number of loan losses from borrowers both large and small -- sovereign countries, major corporations, small businesses, farmers and consumers. The Bank of Montreal has substantially increased its provision for these losses.

Taxes

Another misconception concerns bank taxes.

The Bank's tax payable to the federal Government is determined by two key factors. The first is the tax rate. In recent years, the Bank of Montreal's tax rate has fallen and, as a result, the provision the Bank has made for taxes has not grown at the same rate as profits. This is because the Bank has offered non-taxable, low-interest "loan substitutes" established by the federal Government as a business incentive for certain borrowers. These tax incentives did not benefit the Bank. As intended by the Government, they helped borrowers. The Bank simply passed the tax savings on to borrowers in the form of lower interest rates. Tax rates on ordinary loan revenue have not fallen (see Appendix 14).

The second factor, which has also reduced the Bank's

federal tax bill, is the established system of foreign tax credits. In accordance with accepted principles of international taxation, the Canadian Income Tax Act permits the Bank to claim credits for taxes paid to foreign governments on income earned abroad. This practice is based on the principle that double taxation of overseas profits would be inequitable and seriously harm international business.

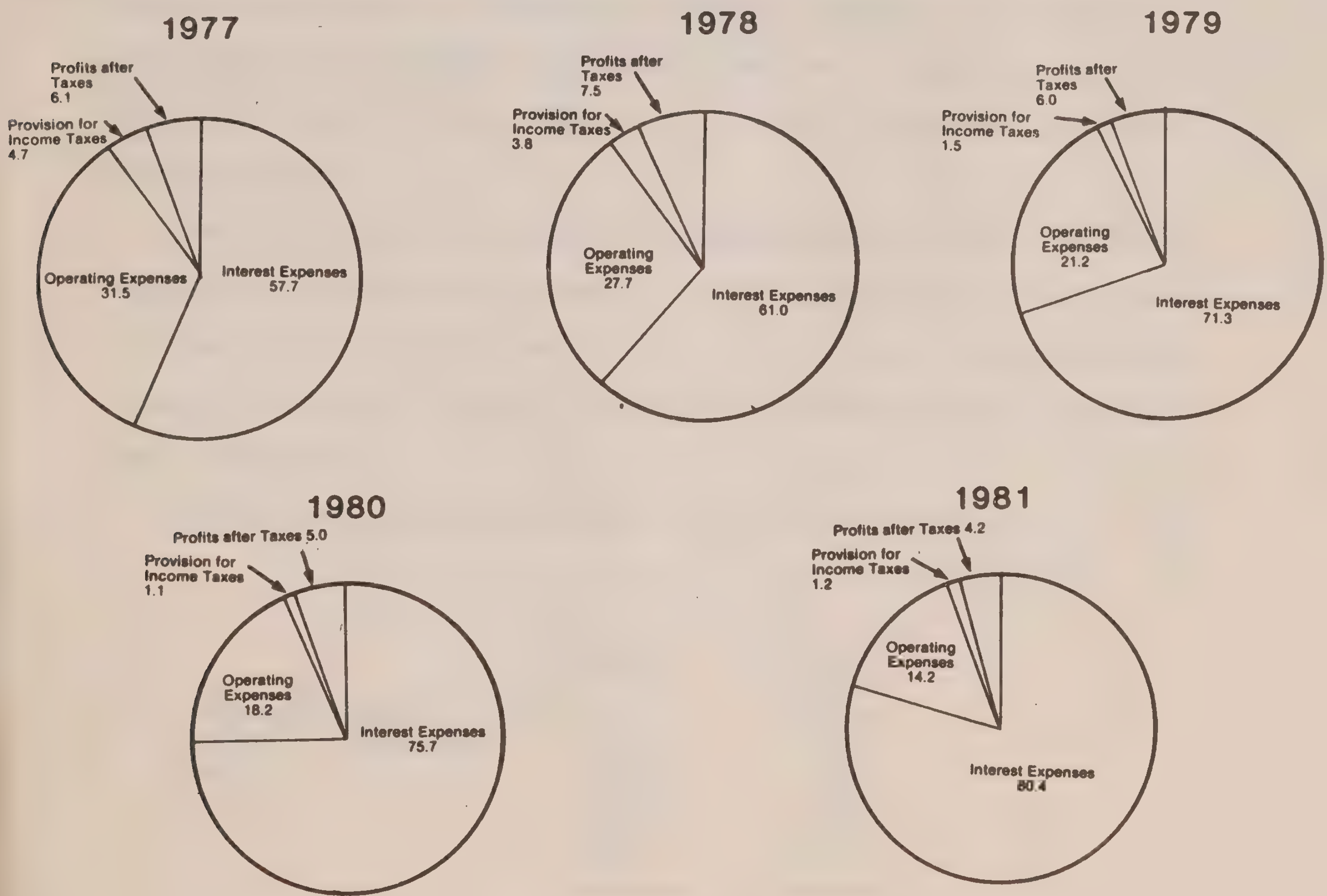
The Bank forgoes hundreds of millions of dollars in interest income each year due to the requirement that it maintain non-interest-bearing deposits with the Bank of Canada. This is not a direct tax, but is a Government-imposed cost of business. The Bank's direct competitors in key markets -- trust companies, mortgage loan companies, credit unions and caisses populaires -- do not bear this cost.

V. REVENUE AND PROFITS*

Over the past five years, the Bank has substantially improved its efficiency and maintained its profitability despite sharp rises in its interest expense. These trends are most evident when profits, interest expense and overhead costs are related to total revenues (see Chart X). Revenue may be

PERCENTAGE BREAKDOWN OF TOTAL REVENUE

CHART X



*See Appendix 15.

viewed as an alternative measure of the Bank's dollar volume of business, although in banking it is a less commonly used measure than assets. Bank profits as a percentage of revenues translate into a profit margin equivalent to the net profit margin of a manufacturing company.

Over the past five years, the Bank's revenue has more than quadrupled -- from $2.0 billion in 1977 to $8.5 billion in 1981 -- reflecting increases in the volume of business, rising interest rates on loans, and growth in other revenue. As is apparent from Chart X, however, interest payments to depositors have absorbed a rapidly increasing portion of Bank revenue -- evidence, again, that banks are vitally affected by high interest rates.

The Bank has been able to accommodate rising interest expense by halving the portion of revenues going to cover overhead (operating expenses) since 1977. Profit margins have remained generally stable, although squeezed somewhat in the last two years.

Compare the revenue pictures of 1977 and 1981:

	1977	1981
Interest expense	57.7%	80.4%
Operating expenses	31.5	14.2
Taxes	4.7	1.2
Profits	6.1	4.2
	100.0%	100.0%

Conclusion

Healthy bank profits are essential: to give confidence to bank shareholders and depositors; to assure the basic soundness and stability of the Canadian banking system; and to fund the borrowing needs of businesses, farmers, homeowners, everyone.

The future development of the Canadian economy depends upon a steady expansion of bank credit -- first, to help finance Canadian business through this difficult period, and then to spur the investment needed to fuel economic recovery.

The question about bank profits must be reduced to this: are they high enough to allow Canadian banks to meet the credit needs of the Canadian economy?

Over the longer term, banks must improve profitability to further build the capital resources vital to loan growth. At the same time productivity must continue to improve. Clearly, when called upon, Canada's banks will play a critical role in generating and sustaining economic recovery. The Bank of Montreal, having moved decisively to expand its capital and, therefore, its lending capacity, is already positioned to help Canada meet the economic challenges that lie ahead.

DEFINITIONS

In reading a brief on economic matters, an understanding of the basic terms used is essential. This is all the more so in the case of the banking industry, which uses in its own special way some terms which for other industries may carry different meanings. The following seven definitions are of particular importance to an understanding of this brief.

1. Bank Assets: financial claims the bank holds on others, plus bank fixed assets. This is the usual measure of a bank's volume of business. First, and by far most significant, is loan money owed to the bank; second, cash resources; third, investments held by the bank; and fourth, although tiny compared to the first three, real estate holdings (fixed assets) owned by the bank.
2. Bank Liabilities: financial claims held by others on the Bank. Money we owe to our depositors.
3. Return on Assets (ROA): after-tax earnings of the bank divided by average total assets. This is a measure of the rate of profitability of a financial institution in terms of what might be called its total volume of business. It compares the profitability of different banks or of a single bank from one time period to another.

4. Spread. There are two common usages: (1) the percentage difference between what the bank pays for funds and what it earns on loans. This is normally how we describe spread for a specific type of loan. (2) net interest income divided by average assets. This is normally how we calculate average bank-wide spread.

5. Return on Equity (ROE): after-tax earnings divided by average shareholders' investment, including accumulated appropriations for losses. This is another measure of profitability, this one of critical importance to bank shareholders. This measure assists an investor to compare investment opportunities among different industries or among firms within a given industry.

6. Capital. This is made up of three components: shareholder money invested in bank stock and earnings reinvested in the bank; bank debentures; and accumulated appropriations for losses.

7. Capital-to-Assets Ratio: total shareholders' investment divided by total assets. This is a measure of the proportion of bank funding which comes from the bank shareholders' own money as opposed to bank deposits. (Capital in this definition excludes bank debentures.)